

VZCZCXRO5976
RR RUEHLH RUEHPW
DE RUEHIL #2829/01 3271358
ZNR UUUUU ZZH
R 231358Z NOV 09
FM AMEMBASSY ISLAMABAD
TO RUEHC/SECSTATE WASHDC 6116
INFO RHEHNSC/NSC WASHINGTON DC
RUEATRS/DEPT OF TREASURY WASHINGTON DC
RUCPDO/DEPT OF COMMERCE WASHINGTON DC
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RUEHKP/AMCONSUL KARACHI 2591
RUEHPW/AMCONSUL PESHAWAR 7238

UNCLAS SECTION 01 OF 02 ISLAMABAD 002829

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E.O. 12958: N/A
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SUBJECT: DIVVYING UP THE TAX REVENUE PIE

REFTEL: A) PESHAWAR 214

1.(SBU) Summary: Pakistan's constitutionally mandated National Finance Commission (NFC) is tasked with meeting every five years to formulate the distribution of revenue between the federal and provincial governments. For the first time since 1997, this body has convened and is currently wrangling over the degree to which factors like a province's population, revenue collection, and level of development should determine the portion of tax revenue that provinces receive. The provinces are taking advantage of the opportunity the NFC provides to pursue unrelated financial grievances against the federal government, such as profits from hydropower owed the provinces by the federal government. While this has slowed the process, members of the Commission are optimistic they will come to the required unanimous agreement before the next budget cycle begins in the spring. End Summary.

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What is the NFC?
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12. (SBU) Taking action overdue by more than seven years, the GOP in July convened the National Finance Commission (NFC), a body charged with formulating the distribution of revenue between the federal and provincial governments. Revenue from most taxes, including income tax, sales tax, customs duties and excise duties broadly make up what is known as the "divisible pool" - the revenue pie that the federal and provincial governments must divide. As directed by Article 160 of the Pakistani Constitution, the Minister of Finance chairs the NFC and each province is represented by both its Provincial Finance Minister, and a private, non-statutory member. Article 160 also stipulates that the NFC re-examine the distribution of the divisible pool at least every five years, although this exercise has not been completed since 1997. The NFC was convened once in the intervening years, in 2003, but the Commission was unable to come to consensus on the division of revenue between the provinces. Since that time, the division has been carried out by Executive Ordinance.

13. (SBU) The NFC must come to a consensus on four matters in order to complete its task and have the resulting agreement take effect for the next five years: the exact composition of the divisible pool; what percentage of the pool will go to the federal government; what percentage of the remaining pool each province will receive; and a number of small, peripheral issues that the NFC is tasked with regulating that are related to taxation policy, but that are not relevant to the divisible pool.

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Vertical Distribution

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14. (SBU) Since the last NFC in 1997, the provinces have received less than 50 percent of the divisible pool, but in this NFC round the Federal Government has publicly indicated that it will likely agree to give the provinces more than half. In late October, the federal government announced that it would give the "maximum resources possible" to the provinces, but that the current fiscal situation would keep the provinces' total share to less than 60 percent of the entire pool. According to Mian Mohammad Yousaf, Secretary of the NFC, the provinces will receive 52 percent of this NFC's divisible pool.

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Horizontal Distribution
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15. (SBU) The sharing out of the divisible pool between the provinces, known as the "horizontal distribution," has historically been based solely on population. The more people in a province, the larger its portion of the pool. However, this formula favors the already developed and more financially stable Punjab and has for years been a source of irritation. Secretary Yousaf said that in recent meetings the provinces have agreed in principle to use multiple criteria, specifically revenue generation, geographical area, and backwardness as elements to be included in the formula for resource distribution. The Secretary estimated, however, that about 60 percent of the resources given to the provinces would continue to be distributed based on population.

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ISLAMABAD 00002829 002 OF 002

Varying Provincial Agendas
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16. (SBU) Dr. Gulfaraz, the non-statutory NFC member from Balochistan, spoke frankly with EconOffs about the motivations of the four provinces regarding the horizontal distribution. His own belief is that the NFC should aim to equalize revenue distribution among and within the provinces and ensure the equalization of public service provision in each province. Balochistan, Gulfaraz said, would like the NFC to consider the problem of inverse population density, which increases public service costs in a large, sparsely populated province like Balochistan. Sindh, however, would like the revenue generation of a province to be a primary factor in the distribution of the divisible pool. In Pakistan, revenue generation is credited to the headquarters of a company, no matter where it is truly generated, meaning that Karachi - as home to most Pakistani company headquarters - receives credit for generating revenue, even if the transactions do not take place in Sindh.

17. (SBU) Representatives from the Northwest Frontier Province (NWFP) are taking yet another tactic, pushing the other NFC members to consider the effects of war in their province and also stressing their lower level of development. The NWFP representatives to the NFC argue that revenue distribution should be used to bring the NWFP up to the same standard of development as the other provinces, as well as mitigate the effects of conflict. Abdul Ghafoor Mirza, the non-statutory NFC member from Punjab and former Finance Secretary, told EconOffs that the break in the traditional horizontal distribution was not certain and that the standard practice of using population as the sole criterion is the most agreeable formula for Punjab - Pakistan's most populous province.

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Peripheral Issues Equal Leverage
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18. (SBU) Mirza said the NFC has already resolved some of the more critical peripheral issues. Primary among these is the NFC decision that the General Sales Tax on Services (GST) will not be included in the divisible pool and will instead be distributed proportionally back to the provinces from which it was generated. For the last several years the GST has been collected by the federal government, as the provinces themselves - although statutorily responsible for

collecting the tax - lacked the technical means to do so. The federal government charged a five percent service fee for collection, and then included the collected funds in the divisible pool for distribution to the provinces. Given that the divisible pool has been distributed based on population, more populous provinces such as Punjab have gotten more of the GST than other provinces, such as Sindh that generates more of the GST. The federal government has also agreed to reduce the service fee it charges from five percent to two to three percent.

¶9. (SBU) Article 161 of the Pakistani Constitution mandates that net profits from hydro-electric power generation should be paid back to the province in which the power was generated, rather than disbursed through the NFC or retained by the federal government. Just as with the GST, however, these power dues were retained by the federal government in recent years. The NWFP delegation threatened to boycott the Karachi round of NFC negotiations after a promised first \$120 million tranche of back hydro-electric payments was delayed by more than two weeks. Both Punjab and the NWFP received a portion of the power dues owed them on the eve of the negotiations, however, and the Karachi round began as planned on November 18.

¶10. (SBU) Comment: As the most recent round of negotiations in Karachi began, members of the Commission were unwilling to predict whether the NFC would come to a consensus before February. However, both Gulfaraz and Mirza were sanguine about the Commission coming to the required unanimous agreement and that the NFC's work would be done before the next federal budget begins to take shape in May.
End comment.

PATTERSON